

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Chavez Analyst: Jeff Garnier Bill Number: AB 1338
Related Bills: See Legislative History Telephone: 845-5322 Introduced Date: February 21, 2003
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Withholding on California Real Estate to 9.3%/ Escrow Person Liable for Penalty

SUMMARY

This bill would:

- Modify the real estate withholding provisions so the withholding more closely matches the actual tax due on the sale of the property,
- Require withholding on the portion of any gain from the sale of a principal residence that is not excluded from taxable income,
- Revise other withholding provisions affecting certain corporations, and real estate escrow persons.

PURPOSE OF THE BILL

The author's staff has indicated that the purpose of the bill is to modify the real estate withholding provisions so the withholding more closely matches the actual tax due on the sale of the property.

EFFECTIVE/OPERATIVE DATE

This bill would be effective and operative for taxable years beginning on or after January 1, 2004.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Under federal law, 10% of the amount realized on the disposition of a U.S. real property interest must be withheld when a foreign investor disposes of that interest in real property. The withholding obligation is generally imposed on the buyer or the withholding agent, who must report the amounts withheld and pay them to the Internal Revenue Service.

Under state law, when California real estate is sold, buyers are required to withhold 3 ⅓% of the total sales price if certain conditions are met.

Generally, withholding is required by the buyer when purchasing California real property and any of the following items are met:

- The seller is an individual or a trust.
- The seller is a corporation that has no permanent place of business in California immediately after the sale of the real property.

Board Position:

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_____ N	_____ OUA	_____ X PENDING

Department Director
Gerald H. Goldberg

Date
3/12/03

For individual sellers, withholding is not required if any of the following are met:

1. The total sales price of the California real property is \$100,000 or less,
2. The buyer did not receive written notification of the withholding requirements,
3. A corporate mortgagee or a beneficiary under a deed of trust is acquiring the property in foreclosure,
4. The seller certifies under penalties of perjury that:
 - The property conveyed was their principal residence,
 - The property is being exchanged under the like-kind exchange provisions of IRC 1031,
 - The property was involuntarily converted or sold as defined under IRC 1033, and
 - The sale results in a loss to the seller.
5. The withholding may be modified if income from the property that is sold is taken into account under the installment method of accounting.

For corporate sellers with no permanent place of business, withholding is not required if either of the following are met:

- The total sales price of the California real property is \$100,000 or less, or
- The buyer did not receive written notification of the withholding requirements.

Corporate sellers with no permanent place of business in California, may request from the FTB a waiver from withholding or a reduced amount of withholding. All requests for waiver or reduced withholding are handled on a case-by-case basis. Generally, requests are granted when:

- There is little or no gain on the transaction,
- The amount otherwise required to be withheld ($3\frac{1}{3}\%$ of the sale price) exceeds the estimated tax on the recognized gain,
- The transaction involves a like-kind exchange,
- The sale will be reported on the installment sale basis,
- The transfer is the result of a foreclosure by an individual,
- The transfer is the result of an involuntary conversion and the transferor intends to replace it with qualified property,
- The transaction involves property that was recently acquired by inheritance or through an estate distribution, or
- The seller is a corporation that certifies it has a permanent place of business in California immediately after the transfer.

Initially a real estate escrow person (REEP) is responsible for withholding. A REEP is defined as the person (including but not limited to an attorney, escrow company, or intermediary) responsible for closing the transaction or is the person in control of payment. California law requires the REEP to inform the buyer of the withholding requirements. If the REEP informs the buyer of the withholding requirements, the REEP is no longer responsible for the withholding. The buyer becomes responsible and is subject to a penalty for failing to withhold. If the REEP fails to properly inform the buyer of the withholding requirements, the REEP remains responsible for the withholding and is subject to a penalty. The penalty for not properly withholding for both the buyer and REEP is the greater of \$500 or 10% of the amount that was required to be withheld. The law prohibits a penalty being assessed on the REEP for failure to properly withhold if the seller reports the gain on the sale of the property and pays the proper amount of tax by the due date or extended due date of the tax return. This provision does not apply to the buyer; therefore, even if the seller timely pays the proper amount of tax, the buyer is still liable for the penalty.

THIS BILL

This bill would change the California real estate withholding requirements by:

- Allowing the seller to elect to have the maximum tax rate (presently 9.3% for individuals and trusts and 8.84% for corporations) of the gain withheld instead of $3\frac{1}{3}\%$ of the sales price. The seller must certify under penalty of perjury that gain reported to the buyer or REEP is correct.
- Requiring withholding at maximum tax rate on the portion of any gain from the sale of a principal residence that is not excluded under IRC Section 121. This would normally mean gains in excess of \$500,000 for married individuals or \$250,000 for single individuals.
- Revising the withholding requirements on corporations with no permanent place of business in California to match the requirements for individuals. This eliminates the corporation waiver process and replaces it with the same statutory scheme in present law for self-certification by individuals.
- Making the real estate escrow person equally and severally liable for real estate withholding. Presently, if the real estate escrow person (REEP) informs the buyer of the withholding requirements, the REEP no longer has any liability for withholding.
- Removing the provision that prohibits a penalty from being assessed (would now allow the penalty) on the REEP for failure to properly withhold if the seller reports the gain on the sale of the property and pays the proper amount of tax by the due date or extended due date of the tax return.
- Clarifying expressly that transfers of real property will not be subject to withholding if they are contributions to capital of controlled corporations and partnerships, sales by estates of a decedent's principal residence, or other sales that do not result in a net recognized gain.

LEGISLATIVE HISTORY

Real estate withholding on non-residents and certain corporations was instituted by statute in 1991.

AB 2065 (Stats. 2002, Ch. 488) expanded the real estate withholding to residents and converted the waiver process for individuals into a certification process.

AB 628 (2003) (Runner) would eliminate real estate withholding on sole proprietors in the trade or business of constructing and selling residential houses. This bill is presently at the Assembly Desk.

AB 1490 (2003) (Benoit) would eliminate real estate withholding on all residences of the seller regardless whether the residence qualifies as the seller's residence. This bill is presently at the Assembly Desk.

OTHER STATES' INFORMATION

The laws of *Illinois, Massachusetts, Michigan, Minnesota, and New York* were reviewed because their tax laws are similar to California's income tax laws. No statutes were found for these states where a withholding requirement is imposed on the sale of real property similar to California's present real estate withholding law or as proposed by this bill.

FISCAL IMPACT

This bill would not materially affect the department's cost and operations.

ECONOMIC IMPACT

Cash-Flow Revenue Estimate

This bill would result in cash-flow losses as follows:

Estimated Cash-Flow* Impact of AB 1338 As Introduced February 21, 2003 Effective for tax years BOA 1/1/2003 Enacted after 6/30/2003 \$ Millions			
	2003-04	2004-05	2005-06
1. W/H at 9.3% on Gains from Sales of Non-Principal Residences	-\$30	-\$3	-\$3
2. W/H on Taxable Gain of Principal Residences	+\$20	+\$2	+\$2
Total	-\$10	-\$1	-\$1

* Ultimate tax liabilities are not affected, only the timing of payments.

Cash-Flow Estimate Discussion

This estimate does not account for changes in employment, personal income, or gross state product that could result from this measure.

This bill is expected to affect only the timing of payments, not ultimate tax liabilities.

The cash-flow impacts of provisions 1 and 2 above were estimated separately as follows. For provision 1, the cash-flow reductions due to withholding the lower of 3.3% of the sale price or 9.3% of net capital gains were estimated based on the department's 1999 and 2000 capital gains samples. The 1999 and 2000 reductions are extrapolated to 2003 using projected growth rates of residential sales. The cash-flow impact of provision 1 is estimated as the average of these two cash-flow losses.

Provision 2 is expected to be a cash-flow gain, estimated as follows. The cash-flow increases due to the 9.3% withholding on net capital gains in excess of the allowed primary residence exclusions were estimated based on the department's 1999 and 2000 capital gains samples. The 1999 and 2000 cash-flow increases are extrapolated to 2003 using projected growth rates of residential sales. The cash-flow impact of provision 2 is estimated as the average of these two cash-flow increases.

The cash-flow impact of AB1338 for fiscal year 2003/04 is estimated to be a cash-flow loss of \$30 million under provision 1, and a cash-flow gain of \$20 million under provision 2, resulting in a net cash-flow loss of \$10 million. This cash-flow loss is largely a one-time event. The term "cash-flow" gain or loss means that while ultimate tax liabilities are not changed, the timing of tax payments through withholding relative to current law by this bill will be affected.

POLICY CONCERNS

- Allowing the taxpayer to elect between $3\frac{1}{3}\%$ of the sales price or 9.3% of the gain will eliminate many taxpayers from having taxes over-withheld.
- Revising the withholding requirements on certain corporations to match the individual requirements and eliminating the corporate waiver process lessens the burden on both the taxpayer and the department by having only one set of rules.
- Making the REEP equally and severally liable for real estate withholding would legally compel the REEP to correctly withhold on California real estate sales. Also, removing the provision that prohibits a penalty being assessed on the REEP for failure to properly withhold if the seller timely pays the proper amount of tax places the same liability on the REEP as the buyer. Under present law the buyer remains liable for the penalty to properly withhold even if the seller reports the gain and timely pays the proper amount of tax. Many of the buyers affected by real estate withholding are purchasing their personal residence and have no other need to understand withholding. The REEP (usually an escrow company) is better equipped to handle the withholding. The prohibition of the penalty on the REEP alone appears not only inequitable, but it defeats the purpose of a penalty. Penalties are generally enacted and assessed to assure future compliance. Making the penalty not assessable until up to 20 months after the transaction (e.g., property sold in January of 2004 and the return is filed in October of 2005) and dependent on the actions of another party (the seller must report the gain and pay the tax, not the REEP) does not compel future compliance.

In addition, this provision would conceptually follow the federal law withholding provisions on nonresident aliens and foreign corporations that specifically require the withholding agent (not necessarily the buyer) to be responsible for the withholding and remitting. Federal law does not permit the waiver of a penalty for a withholding agent if the seller timely paid the proper amount of tax on the transaction. Under federal law, the basic definition of a withholding agent is the person in control of payment. In most cases this would be the REEP.

LEGISLATIVE STAFF CONTACT

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